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No. 82-687

IN THE

Supreme Court of the United States

October Term, 1982

UNITED STATES OF AMERICA,

Petitioner,

v.

ARTHUR YOUNG & COMPANY

and

AMERADA HESS CORPORATION,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether tax accrual workpapers prepared by an independent auditor to assist a corporate taxpayer in complying with the federal securities laws should be accorded a qualified work-product privilege in response to an Internal Revenue Service ("IRS") summons when

(a) the taxpayer's records have been examined by the IRS,

(b) the auditor's workpapers are available to the IRS, and

(c) the IRS has failed to make any showing of special need for the tax accrual workpapers?

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Statement of the Case

The Tax Accrual Workpapers

The Arthur Young tax accrual workpapers* contain no facts relating to Amerada's tax liability that are not either derived from or reflected in the corporation's financial and

*Independent auditor's workpapers of this nature are variously referred to as tax accrual files, tax contingent liability files, or tax pool analysis files.

transactional records and books of account or reported in publicly available documents. Amerada's records and books were produced to the IRS. Arthur Young's audit workpapers have been available to the IRS since the date of the decision below. *See* 677 F.2d at 221. As the Court below emphasized, the "corporation's own books and the audit workpapers furnish the IRS with all the raw data that it needs to calculate the taxpayer's tax liability." *Id.* at 220.

Tax accrual workpapers are prepared by an independent auditor for SEC and financial reporting purposes. They are not part of the tax return workpapers. Those sought in this case were prepared by Arthur Young, as Amerada's independent auditor, in connection with its year-end audit work and its opinion on Amerada's financial statements.

In making its assessment of the adequacy of Amerada's accrual (reserve) for potential tax liability, as reflected in its financial statements, Arthur Young evaluates the projections, hypotheses and speculations of Amerada's financial personnel as well as Amerada's books of account on a number of questions. These include, for example, tax issues which might arise in connection with various corporate transactions, possible objections which the IRS might raise in examining Amerada's returns, possible responses which Amerada might make to any such challenge, estimates of the likelihood of an administrative settlement, and estimates of the outcome of a judicial decision. Arthur Young then prepares its tax accrual workpapers which reflect its judgment, solely for financial reporting purposes, regarding the adequacy of the tax reserve as shown on Amerada's financial statements.

The Court below accordingly found that the tax accrual workpapers set forth the independent auditor's "speculation as to positions that might be taken by the IRS and taxpayer, theoretical analysis, and opinions bearing on the fairness

and reasonableness of the parties' positions (as distinguished from factual transactional data)...." 677 F.2d at 217.*

The Joint IRS Investigation of Amerada

The petition does not describe the status of the joint IRS investigation of Amerada in April 1978 when the summons for Arthur Young's tax accrual workpapers was issued. Contrary to the impression created by the petition (pet. 3), there was at that time no general IRS inquiry into the correctness of Amerada's tax returns. Rather, there was a narrow investigation, primarily criminal in direction, focused exclusively on alleged "questionable payments" by Amerada totaling less than $8,000. An IRS Special Agent (that is, a criminal investigator) was assigned to the case, and Amerada and the IRS entered into an agreement concerning the purposes for which the Special Agent's summonses would be issued. 677 F.2d at 214. The exact nature of this agreement was contested below and the record is unclear on it. *Id.* at 214, 218. The Arthur Young summons was signed by the Special Agent, *id.* at 214, and was issued at a time when the civil audit to determine the correctness of Amerada's tax returns was suspended.

Rather than assess the IRS' motive for issuing the summons, "in an institutional sense," as required by this Court's decision in *United States* v. *LaSalle National Bank,* 437 U.S. 298, 319 (1978), the Court below, for reasons of "judicial economy," assumed that the summons was in aid of the civil audit and that "the IRS [was] not attempting to prove that Amerada [was] guilty of fraud." 677 F.2d at 221. The Government vigorously contested this finding in its Petition for Rehearing and Suggestion for Rehearing En Banc, asserting that the Court's assumption "that this case does not involve a fraud investigation ... is flatly contradicted by the

* In its Manual the IRS recognizes that tax accrual workpapers consist principally of opinions and projections of the taxpayer and independent auditor rather than facts. *See I [Audit] Int. Rev. Man.* (CCH) § 232.8(4) (May 14, 1981).

record, which establishes beyond any doubt that the IRS is conducting a joint investigation of Amerada in which both civil (including civil fraud penalties) and criminal elements remain open and ongoing." Petition for Rehearing and Suggestion for Rehearing En Banc 13-14. There was, in short, considerable confusion in the Court of Appeals concerning the purpose for which the Arthur Young summons was issued, the nature of the agreement between Amerada and the IRS, and the extent to which fraud was involved in the case.

The petition is likewise misleading in its description of the Court of Appeals' holding. The Court held that "the IRS [had] not made a sufficient showing of need to override the [accountant work-product] privilege." 677 F.2d at 221. The basis for this holding was not, as the petition suggests (pet. 5), that Amerada's "own books and the audit workpapers furnish the IRS with all the raw data it needs." The reason that the IRS failed to make a sufficient showing of need, in the Court's view, was that "the IRS [was] not attempting to prove that Amerada [was] guilty of fraud." 677 F.2d at 221. The holding of the Court of Appeals was clearly limited to cases that "[do] not involve allegations of fraud." *Id.* at 220.

Reasons for Denying the Petition

I

THE DECISION BELOW IS IN ACCORD WITH THE DECISIONS OF THIS COURT

The petition argues that the creation by the lower Court of "an accountant work-product privilege, under the rationale of an accountant-client privilege," is "in derogation of this Court's ruling in *Couch* v. *United States*, 409 U.S. 322, 325 (1973), that no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases. . . ." (pet. 6) This argument completely misapprehends the decision below.

The lower Court did not establish a privilege for all communications between accountant and client. Nor did it reach a result based on the rationale of a general accountant-client privilege. Since the decision below neither creates nor relies on an accountant-client privilege, it does not run afoul of this Court's decision in *Couch* v. *United States,* or the decisions of lower courts following *Couch. See, e.g., In re International Horizons, Inc., Debtor,* No. 82-8024 (11th Cir. Oct. 21, 1982).

The Court of Appeals did create a qualified work-product privilege for an independent auditor's tax accrual workpapers in certain limited circumstances. In creating this privilege, the lower Court followed in the path of the Court of Appeals for the Third Circuit in *Hickman* v. *Taylor,* 153 F.2d 212 (3d Cir. 1945), which created a qualified work-product privilege for an attorney's trial preparation materials. The privilege created by the Court of Appeals in *Hickman* was approved by this Court, 329 U.S. 495 (1947), and codified in Fed. R. Civ. P. 26(b)(3).

The purpose of protecting the auditor's tax accrual workpapers is to safeguard the public interest in the auditing function, not, as in the case of an accountant-client privilege, the confidentiality of communications between taxpayer and auditor. The lower Court noted that:

> If the auditor were required to disclose this material [the tax accrual workpapers], which is not used in preparation of the taxpayer's return and is not needed by the IRS to determine the correctness of the taxpayer's return, the auditor would probably be inhibited from creating or maintaining such papers as part of a full and frank exchange useful in complying with the taxpayer's obligations under federal securities laws.

667 F.2d at 217. The Court concluded that:

> The investing public . . . relies most exclusively on the data generated as a result of the SEC laws. It therefore seems to us that this collision [between the responsibilities of the IRS and the SEC] requires that some form of

> privilege be carved out to protect the independent auditing process.

Id. at 220-21.

Like the attorney work-product privilege, the privilege for tax accrual workpapers is qualified and can be overcome by a sufficient showing of need by the IRS. *Id.* at 221. Also, like the attorney work-product privilege, the protection afforded by the privilege is limited to "documents and tangible things"—the tax accrual workpapers—which are prepared by the independent auditor in order to assist in satisfying the requirements of the federal securities laws but which in so doing reflect the settlement position and tax strategy of the taxpayer in the event of an IRS audit or litigation. *Id.* at 220.

The Court below also properly relied upon *Upjohn Co.* v. *United States,* 449 U.S. 383 (1981), in expanding the work-product doctrine of *Hickman* to include an independent auditor's tax accrual workpapers. 677 F.2d at 219-21. It noted that "neither the [Supreme] Court nor Congress expressed an intent to limit the [work-product] doctrine to the discovery context." *Id.* at 219. In *Upjohn,* this Court based its decision in part upon its concern for protecting sensitive communications where full discourse serves a public interest, where opinions and conclusions are involved, and where confidentiality is anticipated. 449 U.S. at 392-397. While the *Upjohn* decision related to attorneys, the broader overtones discernible in that decision motivated the Court below to balance "strong public policies" favoring some protection for the integrity of the market for publicly traded securities against the IRS' claimed need for the information in the independent auditor's tax accrual workpapers. 677 F.2d at 219.

II

THE DECISION BELOW IS NOT IN CONFLICT WITH THE *EL PASO* DECISION

The petition also argues that the decision below "conflicts" with *United States* v. *El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, No. 82-716 (Oct. 22, 1982). (pet. 6) This argument cannot be supported.

Both decisions held that tax accrual workpapers are relevant to an IRS audit. *See United States* v. *El Paso Co., supra*, 682 F.2d at 537-38; *United States* v. *Arthur Young & Co., supra*, 677 F.2d at 219. But while the Court below declined to order the production of tax accrual workpapers prepared by independent auditors in order to protect their work done "to comply with the federal securities laws," *id.* at 219, the *El Paso* court required the production of tax accrual workpapers prepared by the taxpayer. 682 F.2d at 534. The difference in the decisions turns on the difference in the authorship of the workpapers.

El Paso did not involve the question raised by the petition in this case. As the Court in *El Paso* stated, "We need not reach the issue of an accountant work product doctrine because the IRS here summoned the tax pool analysis from the taxpayer itself, not from an independent accountant". 682 F.2d at 537-38 n.7. The two cases are therefore not in conflict.

III

THE DECISION BELOW IS FULLY WITHIN THE POWER OF THE FEDERAL JUDICIARY

The petition also contends that whatever the nature of an independent auditor work-product privilege, its creation by the Court below constitutes an encroachment on legislative prerogative. (pet. 15) This contention is contrary to the decisions of this Court in *Hickman* and *Upjohn* and also ignores the express invitation to the federal courts to create new privileges extended by Congress in Fed. R. Evid. 501.

Fed. R. Evid. 501 provides in relevant part that "the privilege of a witness . . . shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience." This Court has found that Rule 501 "manifested an affirmative intention not to freeze the law of privilege" and that Congress in enacting the rule intended to " 'provide the courts with the flexibility to develop rules of privilege on a case-by-case basis' and to leave the door open to change" (quoting statement of Rep. Hungate at 120 Cong. Rec. 40891 (1974)). *Trammel* v. *United States*, 445 U.S. 40, 47 (1980). *See also, Upjohn Co.* v. *United States, supra*, 449 U.S. at 396-97 (1981); *United States* v. *Gillock*, 445 U.S. 360, 367 (1980). The legislative history of Fed. R. Evid. 501 "clearly indicates that Congress anticipated future recognition, by the courts, of privileges not recognized at the time of passage of the Rule." Garbis and Struntz, *The Second Circuit's Arthur Young Decision: A Privilege for Tax Accrual Workpapers*, 57 J. Tax'n 66, 68 (1982); *see* S. Rep. No. 93-1277, 93d Cong., 2d Sess. 12-13 (1974); 2 D. Louisell and C. Mueller, *Federal Evidence* § 200 (1978); 23 C. Wright and K. Graham, *Federal Practice and Procedure* § 5425 (1980).

The petition's assertion that the risk of SEC prosecution obviates the need for an independent auditor work-product privilege (pet. 13) ignores the rationale of *Upjohn*, in which this Court relied upon Fed. R. Evid. 501 to expand the scope of the attorney-client and work-product privileges. 449 U.S. at 396-97. There, this Court determined that these privileges should be expanded to improve the quality and depth of an attorney's investigation and to encourage the client's compliance with the law, rejecting the Government's argument that "the risk of civil or criminal liability suffices to ensure that corporations will seek legal advice in the absence of the protection of the privilege." *Id.* at 393 n.2. Following *Upjohn*, the Court below similarly reasoned that a qualified independent auditor work-product privilege was necessary to protect the public securities markets against inaccurate

financial information notwithstanding the corporate taxpayer's duty to comply with the federal securities laws under risk of SEC prosecution or civil suit. 677 F.2d at 220.

The Court below also acted pursuant to recognized judicial authority to resolve conflicts among competing Congressional policies. As this Court has observed, substantial countervailing policies of Congress can undercut the otherwise broad latitude given to the IRS in enforcing the nation's tax laws. *United States* v. *Euge*, 444 U.S. 707, 711, 716 n.9 (1980).* Relying on *Euge*, the Court below concluded that the conflict between the public interest in strict enforcement of the tax laws and in accurate, complete financial disclosure mandated by the federal securities laws "requires that some form of privilege be carved out to protect the independent auditing process." 677 F.2d at 221. In reaching this conclusion, the Court emphasized that:

> [W]e are comforted by the knowledge that if Congress feels that this privilege unduly restricts the IRS's authority, it can require that this material be made available, or that taxpayers flag their questionable positions directly on their returns, in line with the suggestions of former Commissioner Kurtz, 32 Tax Law. at 15-16; Cooper, The Avoidance Dynamic: A Tale of Tax Planning, Tax Ethics, and Tax Reform, 80 Colum. L. Rev. 1553, 1612 (1980). Procuring tax

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* *St. Regis Paper Co.* v. *United States*, 368 U.S. 208 (1961), is not to the contrary. In that case there was an express statutory provision for resolution of the conflict between the protection against disclosure of census information in section 9(a) of the Census Act, 13 U.S.C. § 9(a), and the Federal Trade Commission's right to subpoena such information under section 6(b) of its organic Act, 15 U.S.C. § 46(b). *Id.* at 219-20. Unlike this case, there was no conflict of congressional policies in *St. Regis*. In any event, the Court there did not find the alleged policy considerations against disclosure to be substantial enough to warrant the creation of a privilege. *Id.* at 218-19.

> accrual workpapers under § 7602 seems to us to effectuate Commissioner Kurtz's proposals through the back door.

Id. at 221.

Shortly after the judgment below was entered, Congress, in enacting the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248, 96 Stat. 324, § 323(a), to be codified as new Internal Revenue Code § 6661, adopted Commissioner Kurtz's suggestion that taxpayers be encouraged to flag questionable positions on their returns but expressly declined to require disclosure of accountant's workpapers. The Senate report on TEFRA stated, *inter alia*, "the committee intends that the Secretary shall in no event require disclosure of accountant's work papers." S. Rep. No. 97-494, 97th Cong., 2d Sess. 273-74 (1982).

IV

THIS CASE IS NOT APPROPRIATE FOR REVIEW OF THE QUESTION PRESENTED

The Government's contention that certiorari is necessary because the question raised is important and "is likely to recur with frequency" (pet. 7) overlooks both the peculiar factual situation and the narrow holding of the Court below. In addition, subsequent amendments both to the Internal Revenue Code's summons enforcement provisions and to the Internal Revenue Manual make it most unlikely that the problem confronting the Court of Appeals will ever recur.

First, the Court of Appeals' approach was shaped fundamentally by its understanding of the extent to which the IRS was trying to prove fraud. There was considerable confusion as to the nature of the agreement between Amerada and the IRS and as to the Special Agent's purpose in issuing the summons. The Court's holding was predicated on the assumption that the case did "not involve allegations of fraud," 677 F.2d at 220, an assumption in all probability generated by uncertainty as to the scope of the "good-faith"

inquiry mandated by this Court's decision in *LaSalle National Bank*. *Id.* at 218. After the Court of Appeals rendered its decision, however, Congress amended the summons provisions of the Code to provide explicitly that an IRS summons may be issued for "the purpose of inquiring into any offense connected with the administration or enforcement" of the tax laws, effectively ending the uncertainty caused by *LaSalle*. Pub. L. No. 97-248, 96 Stat. 324, § 333(a), amending Internal Revenue Code § 7602(b). The Court of Appeals' analysis of the case thus responded to an uncertain factual situation that is unlikely ever to recur.

Second, the Government's contention that certiorari is necessary overlooks the narrow holding of the decision below. The qualified privilege applies only with respect to tax accrual workpapers prepared by independent auditors who are retained by publicly owned companies to assist them in complying with the federal securities laws. 677 F.2d at 217, 220-21. Further, the privilege attaches to such tax accrual workpapers only when the taxpayer's records have been produced, its accountant's audit workpapers are available, such materials contain all the factual data that the IRS needs to calculate the taxpayer's tax liability, and there is no showing of special need for the tax accrual workpapers. Finally, by limiting the privilege to cases not involving allegations of fraud, the Court below effectively restricted it to civil cases.

Substantially similar limitations on access in civil cases to independent auditor's tax accrual workpapers have been established by the IRS itself in recent revisions of its Guidelines for Requesting Audit or Tax Accrual Workpapers. *See I [Audit] Int. Rev. Man.* (CCH) § 4024.4 (May 14, 1981).* It is impossible to reconcile the petition's objections to the decision below with the position of the IRS in its revised Manual.

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* The revised section 4024.4 of the Internal Revenue Manual is included as the Appendix to this brief.

The revised IRS Manual, now in effect, requires, among other things, that before an examiner may consider requesting an independent auditor's tax accrual workpapers the examination must be substantially completed, specific issues must be identified, facts relating to the identified issues must be requested from the taxpayer, and factual analyses relating to the identified issues must be requested from the taxpayer's accountants. *Id.* at § 4024.4(2). Thereafter, if the examiner determines that a need still exists to inspect tax accrual workpapers, he must seek written approval from the Chief of the Examination Division. *Id.* at § 4024.4(5). Even then, however, the examiner's request must be "limited to those portions of the tax accrual workpapers that are material and relevant and related to the specific issue or issues identified."• *Daily Report for Executives,* DER No. 86 (BNA), May 5, 1981, at J-2 (Remarks of Comm'r R.L. Egger); *see I [Audit] Int. Rev. Man.* (CCH) § 4024.4(3) (May 14, 1981).

If these Guidelines had been in effect in 1978, a summons would not have been issued in this case, which was described by the Court below as a civil case not involving allegations of fraud. 677 F.2d at 220-21.

Finally, the decisions cited in the petition do not support the argument that the issue "is likely to recur with frequency." (pet. 7) All of those decisions were rendered before May 14, 1981, when the revisions to the Manual became effective.

• The petition is incorrect in suggesting that under the revised Manual the IRS can request an independent auditor's tax accrual workpapers "in the course of complex audits of large corporations with substantial tax liabilities." (pet. 7) The complexity of the audit, the size of the corporate taxpayer and the potential tax liability are not the determining factors under the Manual as to the IRS' authority to seek disclosure of an independent auditor's tax accrual workpapers. *I [Audit] Int. Rev. Man.* (CCH) § 4024.4 (May 14, 1981).

The "uniform national rule with respect to the production of.... tax accrual workpapers" (pet. 7) which the petition requests this Court to establish has in large part already been put into effect by the IRS. Through its new Guidelines, the IRS has eliminated the need for certiorari in this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

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APPENDIX

Internal Revenue Manual § 4024.4 (May 14, 1981)

Guidelines for Requesting Audit or Tax Accrual Workpapers

(1) In unusual circumstances, access may be had to the audit or tax accrual workpapers. However, examiners should keep in mind that the taxpayer's records are the primary source of factual data to support the tax return. Accountants audit or tax accrual workpapers should normally be used only when such factual data cannot be obtained from the taxpayer's records and then only as a collateral source for factual data, access to which should be requested with discretion and not as a matter of standard examining procedure. For example, after the examiner has audited the taxpayer's records regarding the reserve for bad debts he/she may request the *audit* workpapers relating to the reserve for bad debts if those workpapers are determined to be necessary. Such a request should be made first to the taxpayer.

(2) Unusual circumstances, for this purpose exist under the following conditions:

(a) a specific issue or issues has been identified by the examiner for which there exists a need for additional facts; and

(b) the examiner has sought from the taxpayer all facts known to the taxpayer relating to the identified issue(s); and

(c) the examiner has sought from the taxpayer's accountant supplementary analysis (not necessarily contained in the workpapers) of facts relating to the identified issue(s).

(3) In any case where the unusual circumstances in (2) above furnish a basis for requesting audit or tax accrual workpapers, the examiner should limit the request only to the portion of the workpapers believed to be material and relevant to the examination. Whether an item is considered

to be "material" is based on the examiner's judgment and an evaluation of the facts and circumstances in the case. However, materiality does not depend entirely on amount. The concept involves qualitative as well as quantitative judgments. For example, the significance of an item or its impact on the tax liability could be some of the factors to be considered in making a judgment regarding materiality.

(4) The reconciliation of Schedule M-1 must be made before considering whether it is necessary to request tax accrual workpapers. Guidelines for the reconciliation are contained in text 232.8 of IRM 4233, Tax Audit Guidelines, Partnerships, Estates and Trusts, and Corporations.

(5) In situations where it is deemed necessary to request tax accrual workpapers in corporate examinations, the prior written approval of the Chief, Examination Division is required. When requesting information pertaining to the tax accrual, the examiner should first take all reasonable means to secure this information from the corporate officer before looking to the independent auditor to provide the information. This will require the examiner to question and where that is not successful to summons a financial officer or the tax manager of the corporation. See IRM 4024.5 concerning use of summons.